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Coherence, coordination and cooperation in the context of the implementation of the Monterrey Consensus, including new challenges and emerging issues

Note by the Secretary-General*

Summary

The present note provides background information and appends a number of points for reflection to inform discussion at the special high-level meeting of 2008. Under the overall theme of "Coherence, coordination and cooperation in the context of the implementation of the Monterrey Consensus, including new challenges and emerging issues", the following five sub-themes have been chosen for the high-level meeting: (a) new initiatives for financing for development; (b) supporting development efforts and enhancing the role of middle-income countries, including in the area of trade; (c) supporting development efforts of least developed countries, including through trade capacity-building; (d) building and sustaining solid financial markets: challenges for international cooperation; and (e) financing climate change adaptation and mitigation.

* The present note was prepared in consultation with staff of the major institutional stakeholders involved in the financing for development process. However, responsibility for its content is solely that of the United Nations Secretariat.

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I. New initiatives on financing for development

1. The Monterrey Consensus adopted on 22 March 2002[1] recognized "the value of exploring innovative sources of finance provided that those sources do not unduly burden developing countries" (para. 44). In the same paragraph, member countries agreed to study "the analysis requested from the Secretary-General on possible innovative sources of finance". The post-Monterrey period has seen a flourishing in the number and variety of new initiatives for financing development. In the context of a new spirit of partnership between developed and developing countries, various groupings have explored together innovative ways of raising financing for development. This partnership "modality" could increasingly become the distinguishing feature of the exploring and implementing of new initiatives for financing development highlighted at Monterrey.

2. The first impetus was the "Initiative for Action against Hunger and Poverty" initiated by France and Brazil in 2004 and supported by Chile, Spain and Germany, which has been referred to in previous reports. In March 2006, the "Leading Group on Solidarity Levies to Fund Development" was established in Paris, with the objective of harnessing support from the international community, first, for the levy on airplane tickets and, second, for continuing to explore and promote other possible levies as well as other innovative sources of finance.

3. Under the aegis of the Leading Group, technical discussions on several potential innovative sources of finance have been undertaken, including "solidarity levies" on, for example, international airplane tickets, currency transaction taxes, taxes on arms trade, taxes on carbon emissions, of migrants' remittances, and enhanced efforts to combat tax evasion and illicit financial transfers. The Leading Group has a permanent secretariat in Paris and a rotating six-month presidency, which was held by Norway between 1 September 2006 and 28 February 2007 and the Republic of Korea between 1 March and 31 August 2007 and is currently held by Senegal, to be followed by Guinea. Important meetings have been held in Brasília, Oslo and Seoul over the course of the last 24 months and the next plenary will be held on 22 and 23 April 2008 in Dakar.

4. Three initiatives are already operational. The International Finance Facility for Immunization (IFFIm) was established in October 2006 as a pilot of the original, more comprehensive proposal of the United Kingdom of Great Britain and Northern Ireland. The Facility is expected to scale up spending by as much as $500 million annually up to 2015 through the issuance of $4 billion worth of floating bonds. Air ticket levies, which were already being implemented as of December 2007 by 9 countries, and to which some 20 countries are committed, have been instituted. These funds are now managed by UNITAID to fund health-related expenditures in developing countries. The Advanced Market Commitments (AMCs) for vaccines initiative, taken up by G7 finance ministers under the leadership of Italy in 2005, will stimulate development and production of vaccines for diseases prevalent in developing countries, where market demand is not sufficient to attract private investment. The pilot project was launched in February 2007.

[1] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

5. Combating capital flight and tax evasion as a powerful means of securing considerable additional innovative financing for development has become a key effort of the Leading Group, under the leadership of Norway, Chile and other countries, as well as non-governmental organizations. Following an initial launch meeting in December 2007, Norway is convening a meeting at the working group level in April 2008.

6. There is renewed international interest in a possible currency-transaction "development levy" of 0.005 per cent, a minuscule tax that is not expected to materially affect market operations while having the potential to generate billions of dollars that can be allocated for development. Organization for Economic Cooperation and Development (OECD) member countries are already raising substantial amounts of revenue on various types of financial transactions taxes with no apparent negative impact on financial markets. The international financial system already has clearing and settlement mechanisms that can manage the collection of this levy at low cost for any one country unilaterally. The difference is that, by its very nature, currency transactions taxes involve more than one country, being levied on the exchange of the currency of one country for that of another. Thus, these are taxes that are best implemented in a cooperative manner among countries.

7. There are other proposals for internationally coordinated taxes on, for example, carbon emissions and taxes on arms purchases, which would have the advantage of providing a significant source of development financing while at the same correcting negative externalities. A carbon tax regime could advance environmental efficiency globally and build on the dynamic launched by the United Nations Framework Convention on Climate Change[2] and the United Nations Climate Change Conference, held in Bali, Indonesia, in December 2007 (see sect. V below).

8. The innovative approach of combining government and industry efforts is a feature of the Millennium Challenge Account (MCA) launched by the United States of America in 2002. The Millennium Challenge Account takes the novel approach of explicitly assisting countries that have "good governance" by committing significant long-term funding through compacts. The programme has 16 signed compacts. In Africa alone, $3.8 billion has been committed and $150 million had been disbursed as of February 2008.

9. The amounts raised and disbursed under new initiatives for financing development have so far been small compared with traditional official development assistance (ODA) and other sources of development finance. An important challenge will thus continue to be that of identifying the best projects, building consensus around them and addressing related implementation issues. Further exploration of new initiatives in financing for development and building up of momentum can be a part of the forthcoming review of the financing for development process in Doha at the end of 2008.

10. In February 2008, the Secretary-General announced the appointment of Philippe Douste-Blazy, former Minister for Foreign Affairs of France and head of UNITAID, as his Special Adviser on Innovative Financing for Development.

[2] United Nations, *Treaty Series*, vol. 1771, No. 30822.

Questions to be addressed under the first sub-theme:

1. **What measures are needed to accelerate the volume of resources raised through new initiatives? What role can the United Nations play in strengthening international cooperation in this area?**

2. **Which new initiatives of financing development have the highest potential for increasing resources with the least burden and the greatest feasibility through simple administrative measures?**

3. **How do we ensure the additionality of revenues raised through innovative methods and ensure that both are aligned to national development strategies?**

4. **What relationships should be promoted between further work in this area and initiatives on the "systemic" front, such as furthering strengthened international cooperation in tax matters?**

II. Supporting development efforts and enhancing the role of middle-income countries, including in the area of trade

11. The increased recognition that the developmental issues specific to middle-income countries comprise challenges and opportunities different from those that face the world's poorest countries (the least developed countries) has prompted a discussion on how the international community can refine its objectives, strategies and instruments in order to support the development efforts of these countries and meet the internationally agreed development goals for all. Using the World Bank's benchmarks, there are 93 middle-income countries or territories in which annual per capita income lies between $906 and $11,115 (in 2006 dollars).

12. The middle-income countries represent 60 per cent of developing countries, are home to almost half of the world's population and about 41 per cent of the world's poor, and, like other developing countries, face daunting challenges in achieving the internationally agreed development goals, including the Millennium Development Goals. Despite significant differences, middle-income countries share several basic challenges, including reducing the levels of poverty and inequality, maintaining social cohesion, building efficient and credible social institutions so as to bring coherence to development efforts, reducing vulnerabilities associated with their integration into international financial markets, and improving their competitive capacity through productive transformation and technological progress.

13. Using the World Bank's classification of "low income" (of which the United Nations least developed country grouping is a subset), only 1 low-income country graduated to middle-income status from 1978 to 2003 while 25 countries dropped down from middle- to low-income status. It is in the international community's interest to ensure that the middle-income countries consolidate development gains and avoid both retrogression in their social progress and the dimming of their growth prospects. To this end, the multilateral development banks need to continue to strengthen their policies and procedures to ensure that they can respond to the demand expressed by middle-income countries for support in an agile and cost-effective manner.

14. There have been two important international conferences focused on middle-income countries in the last few years. The Intergovernmental Conference on Middle-Income Countries, sponsored by the Government of Spain, was held in Madrid on 1 and 2 March 2007 (see A/62/71-E/2007/46, annex, for a summary of the proceedings). The Second International Conference on Development Cooperation with Middle-Income Countries, sponsored by the Government of El Salvador, was held in that country on 3 and 4 October 2007 (see A/62/483-E/2007/90, annex, for the Consensus of El Salvador and the executive summary).

15. As was highlighted both in Madrid and in El Salvador, the stability and soundness of the economies of middle-income countries anchor the economic performance of neighbouring least developed countries because the middle-income countries possess the more prosperous markets in their own subregions. Through their trade, finance, social programmes and participation in multilateral arrangements, the middle-income countries are significant suppliers of international and regional "public goods". Because their economies are greatly affected by international developments, the middle-income countries should be encouraged to be more active in establishing more effective international cooperation processes. Lessons learned from their own development experiences can be shared more broadly in the development community. Middle-income countries are playing a critical role in South-South cooperation and should adopt policies that would expand their contribution to South-South trade and investment and further knowledge exchanges. Upper-income middle-income countries can and should also be encouraged to expand their participation in international assistance activities.

16. A common middle-income country development problem stems from the weakness of many of their domestic institutions. Many middle-income countries have limited fiscal budgets for enhancing the implementation of social policies and income redistribution needed to overcome inequality and reduce poverty. Some suffer from a high level of social and political conflict. Increased participation by civil society and social movements in political processes often contributes significantly to institutional development. The international community can enhance domestic efforts directed at institutional development by advocating and maintaining international rules that support these efforts.

17. The capability of the State to increase revenues and broaden its tax base is crucial to the development of the middle-income countries. The growing integration of the economies of middle-income countries, the increased mobility of capital and tax competition call for greater international coordination, preferably through the United Nations system, in areas such as double taxation, capital flight, tax evasion and fraud. There is significant interest in the middle-income countries in efforts to combat illicit capital flows as this relates to expanding and maintaining their tax base.

18. Despite intense precautionary measures by the middle-income countries, including the accumulation of international reserves, many remain vulnerable to the volatility of international capital flows. While many middle-income countries have made progress in consolidating their economic fundamentals, they have limited policy room for counter-cyclical policies, which often require the capability to manage volatility. Strengthening prudential regulation and financial supervision systems is indispensable to capital flow management and an important prerequisite for financial development. The development of local financial markets is one of the

best means for middle-income countries to secure greater autonomy for their economic policies and to acquire more policy room as they access international capital markets. Ongoing actions in this area should be accelerated.

19. Recent crises suggest that the international financial system has insufficient instruments and resources to deal with sudden reversals in private sector financial movements. middle-income countries have an interest in strengthening international and regional institutions so that these can act as emergency providers of liquidity and, if necessary, lenders of last resort. Because they are significant users of private markets for debt, middle-income countries have an inherent interest in the establishing of more orderly international mechanisms for working out debt to the private sector.

20. Over the last 15 years the middle-income countries have undertaken important efforts to open their economies to the outside world. A number of middle-income countries have started to diversify their exports in manufacturing and services and even to gain market shares for high-technology goods. On the other hand, many middle-income countries are caught in the middle as regards their being no longer cost-competitive like the low-income countries in terms of low labour costs but not yet "quality-competitive enough" in terms of high-tech and the knowledge economy. There is scope in many middle-income countries for improving external competitiveness through product differentiation, and more active international marketing, as well as through moving into more dynamic areas of specialization with a higher technological content and greater value added. This will require steady investment in infrastructure, human resources and technological capabilities.

21. Middle-income countries are not only subject to the rules of multilateral trade, but are increasingly significant participants in the making of these rules. Universal rules on trade shield poorer countries from arbitrary protectionist barriers in rich countries. At the same time, flexibility in the implementation of these rules is important in order for many middle-income countries to gradually adjust to a more competitive global environment. More efforts to address and arrest non-tariff barriers would also be important in enhancing market entry conditions. Special and differential treatment provisions are therefore important in achieving a favourable outcome in the current round of negotiations. They should allow the middle-income countries longer implementation periods and other transitional arrangements, without excluding them from the obligations under these agreements.

22. In the negotiations on non-agricultural market access (NAMA), middle-income countries need to ensure that the outcome creates the necessary incentives and signals for their economies to develop and diversify their sectors of comparative advantage. They should also participate in the further opening of South-South trade. Market access for agriculture products are also very important for middle-income countries and it is critical for the Doha Development Round negotiations to reduce the high levels of tariff protection and market distortions created by subsidies. Trade in services also has an important potential among middle-income countries and liberalization needs to be achieved in sectors and modes that are of interest to them.

Questions to be addressed under the second sub-theme:

5. What are the main policy lessons to be drawn from the Madrid and El Salvador conferences? How should problems of specific relevance to middle-income countries be "mainstreamed" into the development work

of the United Nations, including, inter alia, the financing for development process?

6. **What actions should middle-income countries themselves take to ensure that their legitimate interests and concerns are taken duly into account in international economic discussions, including those in the United Nations?**

7. **What prevents the middle-income countries from "self-organizing" more extensively to increase their participation and voice in international rule-making?**

8. **How can the international community assist middle-income countries in the efforts to improve their tax and revenue collection and reduce capital flight?**

III. Supporting development efforts of least developed countries, including through trade capacity-building

23. The Monterrey Consensus reaffirmed the commitment of the international community to the Programme of Action for the Least Developed Countries for the Decade 2001-2010 (known as the Brussels Programme of Action),[3] adopted by the Third United Nations Conference on the Least Developed Countries in Brussels in 2001. In the statement launching the World Trade Organization's Doha Round of negotiations, the parties committed "to address the marginalization of the least developed countries in international trade as well as the work programme adopted to examine issues related to the trade of small economies" (quoted in para. 31 of the Monterrey Consensus). These commitments, among others, embody the stated determination of the global community to recognize and provide special assistance to the development efforts of the group of the world's 50 least developed countries.

24. In the period since the Consensus, a period characterized by elevated rates of growth in the global economy, least developed countries have achieved higher rates of growth and notably higher rates of growth of exports and inflows of foreign direct investments. As indicated in the 9 May 2007 report of the Secretary-General on the implementation of the Programme of Action (A/62/79–E/2007/63 and Corr.1), in 2005, 30 least developed countries had met or were on track towards meeting the Brussels growth target compared with 24 in the period 2000-2004 (para. 6). least developed countries in Africa were at or close to the targets during this period of strong global growth and high commodity prices. The share of least developed countries in world exports increased from 0.68 per cent in 2004 to 0.90 per cent in 2006, but "this increase was entirely due to oil exports" (para. 50).

25. As noted in *The Least Developed Countries Report 2006: Developing Productive Capacities*,[4] these developments have not translated sufficiently into poverty reduction. The period of the Brussels Programme of Action coincides with the first decade in which the rate of growth of the economically active population outside agriculture is expected to be greater than the rate of growth of the economically active population within agriculture. While agricultural development will continue to be an indispensable ingredient in least developed countries efforts

[3] A/CONF.191/13, chap. I.

[4] United Nations publication, Sales No. E.06.II.D.9.

to move out of poverty, this important transition necessitates a shift in attention from improving agriculture and exports to advancing domestic productive capacities for sustained growth and poverty reduction. Upgrading of those countries' services economy will also be important.

26. A country's "productive capacity" is defined as its capacity to produce goods and services to enable it to grow and diversify its production. Building this capacity requires the promotion of productive resources, entrepreneurial capabilities, and production linkages. Because the private sector is relatively underdeveloped in least developed countries, State involvement in the areas of capital accumulation (especially infrastructure development), technological identification and adaptation, and structural change is called for. In fact, the building of State capability towards greater effectiveness is considered part of the development effort itself.

27. The international community has to step up its efforts to meet its commitments towards least developed countries. Donors are not on track in regard to the target of 0.20 per cent of gross national income for ODA by 2010. In the aforementioned report of the Secretary-General (para. 63), it was noted that in 2005 "only 6 out of 22 donors met the 0.20 per cent target, down from 7 in 2004, and an additional 1 donor was on track to meet it in 2010, down from 3 in 2004". Donor support for capacity-building in trade in least developed countries fell from 59 per cent of the total, even though this type of assistance to developing countries overall increased by 12 per cent.

28. The recent record confirms that trade can be an engine of growth for least developed countries, especially when trade expansion is associated with improved domestic productive capacity. To maximize the benefits of trade, the trade policy of least developed countries should be tailored to specific starting conditions and oriented towards building diversified and sustainable improvements in economic capability. In textiles and clothing, where the least developed countries have the potential to compete in a manufacturing sector, their exports decreased by 5 per cent annually between 2004 and 2006. Achieving competitiveness in this sector, which is critical in supporting employment, private sector development, and modernization, requires precisely the kind of domestic capability advances discussed above.

29. On the external side, granting increased market access to least developed countries is a necessary but not a sufficient condition for ensuring that trade has a beneficial impact on their development. Supply capabilities in most least developed countries are inadequate, as indicated by their average utilization rate of only 70 per cent of the Generalized System of Preferences. Recent international activities undertaken under the rubric of "Aid for Trade" have overturned the previous adage of "trade, not aid" and recognize the potential that international cooperation can play in least developed countries trade development efforts. Because least developed countries exports are more heavily dependent on trade preferences than those from other developing countries, improving their supply capability in the face of impending erosion of these preferences through adoption of the proposals in the Doha Round of trade talks is an urgent task.

30. Least developed countries have accessed aid-for-trade support through the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries. The objective of the framework is to assist these countries in mainstreaming trade in their national development strategies and poverty reduction strategy papers. As of November 2007, 29 countries had completed their Diagnostic

Trade Integration Studies (DTIS), 11 countries had held technical reviews (required before a Diagnostic Trade Integration Study is agreed), and 5 countries have qualified for the technical review. The most tangible aid for trade support activities occur after donors take up the list of trade capacity-building projects that have been identified by the Diagnostic Trade Integration Studies. So far, the funding generated from Diagnostic Trade Integration Studies listings has been quite limited and donors have to step up to the plate on a country-by-country basis to fulfil their Monterrey commitments. The lesson derived from the exercise has been that this process was most successful in countries with strong ownership and in-country trade champions able to push the agenda forward.

31. The Integrated Framework itself, with a new secretariat, was enhanced in the beginning of 2008, with a funding increase to a total of $400 million, or about $8 million per country over five years. The Enhanced Integrated Framework comes with increased, additional predictable financial resources to implement action matrices; strengthened in country capacities to manage, implement and monitor the Integrated Framework process; and enhanced Integrated Framework global governance. It is clear that this level of funding is not aid for trade per se but mostly funding to *plan* for aid for trade, while it is also true that there are other channels for funding aid for trade, including significant support from the World Bank. Given the domestic capabilities of least developed countries, typically quite a large portion of these funds are absorbed by foreign consultancies. Nevertheless, the production of the Diagnostic Trade Integration Studies is a most critical step and a successful outcome would be one that generates sufficient confidence on the part of both domestic constituencies and donors for undertaking trade capacity-building projects that reduce poverty at the same time.

Questions to be addressed under the third sub-theme:

9. **How can least developed countries reshape their development strategies so that a greater proportion of growth translates into poverty reduction?**

10. **What are the kinds of capacities in the Governments of least developed countries that need to be enhanced so that those Governments can play an effective role in developing both their industrial and their agricultural sectors?**

11. **What kind of aid projects would be most promising in terms of assisting least developed countries in taking advantage of their preferential access to developed-country markets?**

12. **How can both Governments of least developed countries and the donor community work together to improve the chances of funding projects identified in the Diagnostic Trade Integration Studies documents?**

IV. Building and sustaining solid financial markets: challenges for international cooperation

32. The Monterrey Consensus highlighted the importance of "encouraging the orderly development of capital markets through sound banking systems and other institutional arrangements aimed at addressing development financing needs" (para. 17). Financial markets in both developed and developing countries have seen enormous growth since 2002, a period characterized by elevated levels of economic growth and abundant liquidity. In the developing world, this period saw advances in macroeconomic management, strengthened fiscal balances, and improved debt indicators, all of which provided the platform for the development of domestic financial institutions. In the industrialized economies, this was a time of rapid credit expansion and financial innovation.

33. Experiences in financial market development distilled from the work of the World Bank and the International Monetary Fund (IMF) emphasize the importance of more diversification; financial structures with more balance (for example, between debt and equity); more involvement of foreign banks in emerging markets' financial systems to spur modernization; and better enforcement of both contracts and regulations. The effort to understand the successful development of these markets, particularly in emerging economies, has made it clear that the financial sector will try constantly to obtain exemptions from rules that limit profitability, so regulation must be seen as an evolutionary process. Prevention of financial failure is not costless, and a heavy regulatory approach is not warranted. However, a richer set of regulatory instruments can be used to protect financial systems more successfully against crisis, while preserving the systems' growth-enhancing effectiveness. In emerging economies, these lessons are being applied and have improved the stability of their financial sectors and expanded the diversity of the kinds of financial instruments traded. In conjunction with their improved macroeconomic balances, stronger domestic financial markets have made emerging economies more resilient in the face of the ongoing crisis.

34. While innovation in financial instruments and increased risk-taking have been historical features of financial market expansion, these episodes have very frequently generated a spiralling expansion of investment and ever-rising asset prices, often coming to an end when the prices of those assets have far exceeded their true economic value. Lessons learned from these crashes have led, in turn, to innovations in supervision and regulation, financial disclosure, and investor protection, which eventually become customary features of the operation of the market. Deriving the appropriate lessons from the current financial turmoil, in an era of globalized markets and economic interdependence, is therefore critical.

35. In the current episode, strong global growth, relatively low interest rates (and the associated increased demand for riskier, higher-yielding assets) and rapid financial innovation resulted in a considerable reduction of credit standards. The process of "securitization", by which streams of future cash inflows (such as mortgage payments) are converted into bonds and these bonds are, in turn, sold to other investors, became increasingly complex and opaque. While mortgage securities have generally been considered safe investments, by packaging the more risky borrowers with higher-quality borrowers in one instrument, financial institutions were able to satisfy the demand for higher-yielding assets. In order to maintain the apparent credit quality of these packages, financial institutions often

set up off-balance sheet corporations (so-called special investment vehicles) which would guarantee the servicing of (providing of liquidity for) the more risky portions of these packages by standing ready to sell off other assets. Eventually, wide segments of the investor community, including pensions, student loan funds and non-United States financial institutions, were holding portfolios in these types of packages (known variously as "collateralized debt obligations", "asset-backed securities" and "structured credit products"). In the United States, enrolment of risky (so-called sub-prime) mortgage borrowers swelled to supply the demand.

36. Rising defaults and falling home prices in the United States sub-prime mortgage market led off in spring 2007 and turned, in July and August, into severe disruptions in the functioning of financial markets in the context of uncertainty regarding the creditworthiness of participating financial institutions. In mid-September 2007, the world witnessed the first bank run in a major industrialized country since the 1930s, against Northern Rock Bank when, as a mortgage lending bank, it could not raise sufficient liquidity in financial markets that had seized up because of the sub-prime crisis; in February 2008, the Government of the United Kingdom was compelled to nationalize this bank. Since the last quarter of 2007, major financial institutions in the United States and Europe (such as Citibank and UBS) have undertaken major recapitalizations by obtaining cash infusions, notably from sovereign wealth funds.

37. Since August 2007, United States and European monetary authorities have been injecting significant liquidity (and, in the case of the United States, lowering interest rates) at various points to prevent a seizing up of their financial markets. In the short term, the most urgent task is to restore confidence in the financial institutions via realistic asset pricing and full loss disclosures and replenishment of capital buffers, as well as through central bank liquidity operations. While an orderly process of financial rehabilitation has to commence as a first step, these moves have not addressed the underlying bases of the disruptions.

38. While an overreaction to the crisis by learning "too early" or "too much" must be avoided, the potential impact of the crisis had become sufficiently widespread by October 2007 for the G7 finance ministers and central bank governors to request that the Financial Stability Forum submit a report on the ongoing financial turbulence by April 2008. The interim report released by the Forum on 9 February 2008 indicates that many time-tested elements in the building of financial markets, such as transparency, risk dispersal, incentive compatibility in risk-taking, and the containment of regulatory shopping or avoidance, still apply. Another long-standing lesson, still mostly in potential form at the time of this writing, is that financial sector crashes have enormous capability to cause the collapse of the real economy — even a healthy one — in terms of employment, growth, trade and investment. An important aspect of this crisis is that, in the present era of globalization, the financial and real sector causes and consequences are global, implying that the necessary responses must also be global, that is to say, internationally cooperative and concerted.

International cooperation challenges in the financial sector

39. In the case of financial markets, the crisis throws light on a number of serious shortcomings both in the markets themselves and in regulatory and supervisory

systems. Financial institutions have increased their use of risk-transferring mechanisms and have done so across national borders. In industrialized economies, the "originate-to-transfer" model of credit expansion rapidly replaced the old "originate-to-hold" model. In the latter approach, banks that had originated the loans expected to hold these assets in their balance sheets until they were fully paid off and had strong incentives to assess the creditworthiness of the projects they had lent to. In the now dominant originate-to-transfer model, the creation of loans for immediate securitization and sale has reduced the incentives for originators to maintain credit standards.

40. In recent years, there arose many new institutions, including those that could originate lending for home loans, that have not been subject to the kinds of regulations to which banks are normally subject. As a result, a significant share of financial market activities fall outside the focus of regulators and supervisors. One issue that arises is whether regulations should begin to encompass these institutions and what the costs would be if regulatory oversight was extended. There appears to be wide agreement that State regulation and supervision over the originate-to-transfer model should be improved so as to make lenders more cognizant of the riskiness of their loans and thus restore incentives for originators to maintain credit quality. It would also be important to consider some standardization in the description of financial instruments. Financial instruments need to be structured in such a way as to enable savers and investors to see clearly what they are buying.

41. International cooperation is required in setting standards and modifying regulatory practices. More intrusive and costly regulation and standards within one national jurisdiction would bestow undue advantages on competitors based in other jurisdictions. With the existence of globalized financial markets, the activities of the less regulated competitors would not necessarily be confined to their home markets and could also undermine the stability of the more regulated areas.

42. The experience of recent months also exposed the fact that, in the end, following the period of intense innovation, the final credit risk has remained concentrated as liabilities of the commercial banking system, including those assets that it "offloaded" into off-balance sheet vehicles. Risk has proved to be considerably more concentrated than market participants and supervisory agencies believed. Since commercial banks are indispensable participants in credit markets, their loss of credit reputation has caused sudden stops in some smaller financial sub-markets.

43. The recent market turbulence has highlighted the lack of transparency both in the new instruments themselves and in the markets more broadly. As crisis unfolded, investors realized that they were much less informed than they had originally thought. The complex structures of the instruments and the lack of transparency with regard to the underlying assets backing those instruments made them very difficult to value especially when market liquidity dried up under stress. At the same time, concerns have been confirmed about the lack of transparency as to where the risks — widely distributed to investors all over the globe by means of securitization — reside in the financial system. Uncertainty about the location and size of potential losses has contributed importantly to elevated risk aversion, the sudden liquidity crunch and major disruptions in the money and credit markets. International cooperation in effecting disclosure of critical information is called for.

44. The existing reporting requirements of the banking sector do not allow for a full assessment of the exposure of banks to the new types of instruments. The disclosure requirements under Basel II standards are considered to be more effective in enhancing transparency and risk management. It is critical that financial institutions establish sound supervisory review processes (the so-called Pillar II) and provide an accurate disclosure of market risk (the so-called Pillar III). Nevertheless, there is a view that, in addition to the implementation of Basel II and actions to improve the information and disclosure practices expected from market participants, new regulations may be needed to induce parties to reveal information that they would not otherwise disclose.

45. Recent events have drawn attention once again to the quality of credit ratings and the role of credit-rating agencies in the regulatory process, issues that were also raised during the Asian financial crisis of the late 1990s. Credit-rating agencies appear to have underestimated the risks contained in the new financial instruments. Too many investors appear to have relied mechanically on these credit ratings and failed to make their own informed assessments. The credit rating industry is dominated by three companies and is thus a truly global, extraterritorial operation whose judgements have a profound impact on national financial markets. Questions have been raised about the independence of their credit assessments, since in many cases they are also credit advisers to the same entities.

46. The crisis has highlighted the importance of greater international cooperation in financial sector monitoring and regulation, which, while remaining basically national in nature, have considerable cross-border effects. It has demonstrated the importance of better coordination and interaction among supervisors, regulators, central bankers and finance ministries within individual countries, as cooperation at international level is only as good as cooperation at domestic level. Efforts need to be intensified to strengthen national and international arrangements for information-sharing and coordinated actions among agencies responsible for supervisory oversight, the provision of liquidity and bank soundness.

47. The unprecedented liquidity injections by central banks around the world have raised the issue of appropriate and effective approaches to joint central bank interventions in global financial markets in times of systemic stress.

International cooperation challenges in the global economy

48. In the case of the global real sector, the first step in efforts to minimize the potentially dislocating impact of the financial market turmoil should be establishment of policies to prevent a sudden unwinding of the global imbalances in trade and finance built up in the recent period. These imbalances had fuelled the previous period of abundant global finance, low interest rates, and private risk-taking. The trade deficits of the United States, in particular, flooded world markets with dollar balances and these were also financed by the enormous reserve build-up, especially in East Asia, also in dollar balances, by the emerging economies. As the financial markets unwind their excesses in risk exposure, the danger is that this can spark a disorderly adjustment in trade and growth, through over-adjustment in exchange rates and drastic falls in commodity prices. While price and exchange rate adjustments need to occur through time, the orderly rebalancing of demand, which

has been needed for years, through multilateral cooperation is critical to minimizing the damage to the global real sector.

49. Progress in reducing the global current-account imbalances is therefore needed. It is critical that there be adjustment over time in prices and exchange rates and a measured rebalancing of demand. A precipitous and uncontrolled fall in the value of the United States dollar and a prolonged United States recession are certainly not in the interest of the international community. Deep declines in exports to the United States would reduce global growth and exert downward pressure on commodity prices, hurting, in turn, many developing countries.

50. As explained in the *World Economic Situation and Prospects 2007*,[5] a coordinated international approach in which countries with export surpluses, particularly in East Asia, attend to boosting domestic demand while gradually appreciating their currency values would make up for the possible deflationary effects of a slowdown in the United States and facilitate the adjustment. Recent calculations suggest that for countries with large trade surpluses, particularly those in Asia, policies that increased those economies' reliance on domestic spending would reduce their export surplus, improve their performance on domestic social objectives and be helpful in respect of the global rebalancing of demand.

51. The key obstacle is that international processes are inadequately designed to facilitate macroeconomic coordination and cooperation and have, since 1971, relied on ad hoc agreements among systemically important countries, such as that emanating from the Louvre Accord on exchange rates in 1988. In 2007, IMF had launched a new vehicle for multilateral consultations, involving China, the euro area, Japan, Saudi Arabia and the United States, aimed at fostering discussion on reducing the global current-account imbalances while maintaining growth. In a report to the International Monetary and Financial Committee of the IMF Board of Governors in April 2007, participants in the talks made important commitments aimed at reducing global imbalances. However, progress in implementing the commitments has been limited. For the moment, the current-account surpluses in China, Japan and emerging Asian economies have continued to rise. Moreover, such a mechanism is often seen as lacking the full authority and legitimacy that could be provided by one that is more universally representative.

52. As articulated in *World Economic Situation and Prospects 2007*, it is important to find appropriate and effective means of monitoring the implementation efforts of the parties to the agreement. One possible means would be to have parties issue multi-year schedules for the agreed policy adjustments and targets. However, in order to be credible, commitments must be attainable and readily monitored, and this would require that they be explicit, measurable and public in character.

Questions to be addressed under the fourth sub-theme:

13. What steps should be taken to bolster both national and international oversight of financial markets? What should be the role of bodies of the United Nations system, such as IMF, in this effort?

[5] United Nations publication, Sales No. E.07.II.C.2.

14. In light of the recent financial market turmoil, should the scope of regulatory coverage be expanded (broadened)? What would be the role of international cooperation in regulatory reform?

15. What should be done internationally to limit the impact of financial turmoil on the real economy?

16. What are the policy implications of the financial turmoil for developing and transition economies?

V. Financing climate change adaptation and mitigation

53. The challenge of financing climate change adaptation and mitigation will need to be squarely addressed in the two-year period culminating in the fifteenth session of the Conference of the Parties to the United Nations Framework Convention on Climate Change, to be held in Copenhagen in November-December 2009. Financing is one of the four pillars of the Bali road map; it is one of two indispensable means, technology being the other, by which countries can expect to achieve the remaining two pillars, namely, significant greenhouse gas mitigation and adaptation to climate change.

54. The financing challenge can be broken into a number of components: how much will be needed; and who will provide it, and to whom, for what, and on what terms. It will be important to deal with the issue of whether existing mechanisms — **and, most importantly, their governance arrangements** — can be expected to provide financing on the scale and in the form required and, if not, how they can be enhanced and what other financing mechanisms may be needed to fill financing gaps. Also, given the principle of "common but differentiated responsibilities" embodied in the United Nations Framework Convention on Climate Change and the Kyoto Protocol thereto,[6] the financing discussion must address the central question of appropriate financial transfers from the industrialized countries (the so-called Annex 1 countries) to non-Annex 1 countries in order to assist the latter in both adaptation and mitigation. A growing number of new financing mechanisms are emerging, though some are still on the drawing board and are unlikely to be able to deal with the scale of the climate change agenda on their own. New mechanisms include two World Bank carbon facilities, the United Kingdom-initiated Environmental Transformation Fund, the United States-initiated Clean Technology Fund, among others. The Global Environment Facility plays an important role in responding to the needs of the Convention in operating the financial mechanism for the implementation of the United Nations Framework Convention on Climate Change.

Financing of adaptation

55. National Governments are faced with the challenge of adapting to climate change or having their economies and societies bear the costs of its adverse impacts or both. Climate change will impact development prospects in varying degrees. Adaptation must be factored explicitly into development plans, including investment

[6] FCCC/CP/1997/Add.1, decision 1/CP.3, annex.

programmes, in all countries, especially those that are most exposed to the adverse effects of climate change. For countries that are especially vulnerable, the investment requirements of adaptation may be significant in relation to Government budgets and even to gross domestic product (GDP). According to the Stern Review, the cost of adaptation to climate change risks in the developing world is in the range of $4 billion to $37 billion per year.

56. Given the very small contribution to cumulative greenhouse gas emissions of many of the most vulnerable countries, there is a strong equity case to be made for the international community's providing financing to help them meet their adaptation needs. Such provision is embodied in the United Nations Framework Convention on Climate Change in the form of a number of special funds. Under the Kyoto Protocol, the Adaptation Fund, which is due to become operational in the near future with the Global Environment Facility as secretariat and the World Bank as trustee but is to be governed by an independent board, is to be financed from a 2 per cent levy on transactions under the Kyoto Protocol's Clean Development Mechanism. Consideration is currently being given under the United Nations Framework Convention on Climate Change to broadening the levy to include all Kyoto-related carbon market transactions instead of restricting taxation to Clean Development Mechanism transactions only. However, given the much smaller amount of Joint Implementation transactions compared with those under the Clean Development Mechanism, the additional contribution to be provided by emission reduction units under the Joint Implementation is not expected to be of large significance. The revenue streams into the Fund would be significantly augmented as the issuances of the emission reductions increase and if their prices rise. In addition, if emissions trading, according to article 17 of the Kyoto Protocol, became significant and was similarly taxed, larger revenue streams could be generated.

57. Another suggestion is for a GDP-based levy on Annex 1 countries to finance adaptation, providing a separate dedicated funding stream beyond any increment to ODA. The already strained performance of developed countries in respect of delivering on existing ODA commitments raises doubts about this approach.

58. Technologies for adaptation to climate change will be of benefit to many countries, and the costs of such development could be shared. This is the case, for instance, with drought- and flood-resistant crop varieties, among others. As in the green revolution, the international community now has a role to play in financing research and development for crop technologies needed to adapt to climate change, especially in Africa, whose agriculture is likely to be most adversely impacted. There is a strong case for international public finance in technology development and adaptation and for strengthened regional cooperation.

Financing of mitigation

59. Climate change mitigation will require, in the first instance, the reduction of greenhouse gas emissions from energy and industrial processes, and from land use, land-use changes and forest activities, such as deforestation and forest degradation.

60. A number of options exist for reducing emissions by managing energy demand and employing low-carbon energy supplies that can contribute to low-carbon economic growth. Yet, in order to achieve adequate levels of emissions reductions there needs to be cohesion in the following three areas:

- The technologies involved, including the physical and capacity-related constraints on deploying them
- The investment required: who will provide it, the mechanisms that will be used, and its cost
- The policies that will offer the most effective incentives to providers of both technology and capital to implement lower-emission solutions.

61. Policies and institutions have an important influence on the scope for and cost of technology deployment. The questions who will provide the investment and through what mechanisms get to the heart of the financing issue. As indicated in the *Human Development Report 2007/2008: Fighting Climate Change: Human Solidarity in a Divided World*,[7] while the private sector has a critical role to play, Governments have a necessary role in setting regulatory standards and in supporting low-carbon research, development and deployment. Policies have to depend on the technologies under consideration, the stage of their development and the risks associated with their development and deployment, but also on the outcome of international negotiations and cooperation efforts.

62. The International Energy Agency (IEA) estimates energy investment requirements to meet growing demand at $20 trillion to 2030. There is also substantial existing electricity-generation capacity in developed countries which will need to be retired and replaced over this time period, including both fossil fuel-based generation and other forms (notably nuclear). What will be the financial implications of steering the major share of the required investment towards low-carbon energy technologies? How will such a reorientation of investment affect the total energy investment budget?

63. One part of the answer entails reducing the energy intensity of economic growth. Reduced energy demand translates into reduced investment requirements for new power plants and energy supply generally. This approach, however, only manages to lower 2030 emissions below a business-as-usual baseline by less than 5 per cent, which is far from the range of reductions needed.

64. A second part of the answer entails meeting a significant portion of incremental or replacement energy demand through existing low-carbon energy technologies which either are already commercially competitive or could be if only institutional and policy distortions favouring fossil fuels or less efficient energy sources were removed. Sugar-cane ethanol (used primarily as transport fuel) faces significant trade barriers, while renewables-based small-scale and intermittent power generation faces institutional barriers in many markets.

65. A third part of the answer has to do with how fast and how far policies, measures and institutional arrangements to promote research and development and accelerated technology deployment can lower costs of low-carbon technologies to the point where they can be deployed competitively with fossil fuel-based alternatives. If and when a given low-carbon power generation technology becomes cost-competitive with the relevant carbon-based alternative, investors can be expected to choose the low-carbon technology. Learning economies associated with the scale of technology deployment suggest a role for government, government-induced, or government-coordinated investment in deployment of alternative

[7] Basingstoke, United Kingdom, Palgrave Macmillan, 2007.

technologies. One example in this regard involves the use of preferential feed-in electricity tariffs for suppliers of renewable-based power to the grid.

66. Finance is needed both for research and development for new energy and other technologies, and for the deployment of those technologies experimentally at first and eventually on a large scale, including through technology transfer to developing countries. A key requirement of large-scale deployment will be investment in the infrastructure required to support the new energy technologies. The public sector would almost certainly need to put in a substantial fraction of the investment. Private sector actors might tend to underinvest in technology development because market prices do not fully reflect the costs of carbon emissions and/or emission reduction revenue streams might not suffice to pay back their investments, and if they are unsure whether they can capture all the gains from their inventions. These factors argue for some form of public support for basic pre-commercial climate technology research and development and/or pooling of risks and rewards through collaborative private sector research and development and/or private sector partnerships.

67. The fact that slowing climate change is a shared objective suggests a research and development approach based on international collaboration and technology-sharing. The importance of rapid deployment of newly developed technologies — for example, for carbon capture and storage — in developing countries suggests the need for their early involvement in research and development and technology demonstration efforts.

68. Trust funds have been employed or proposed as a vehicle through which to address certain financing problems. The United Kingdom Carbon Trust, for example, is a Government-funded independent company which has provided tens of millions of dollars to clean technology businesses with demonstrated commercial potential. The rationale for early deployment is both cost reduction and cost revelation, that is to say, provision to policymakers of firm cost information on which to base decisions about stricter regulation.

69. An international trust fund for low-carbon technology research and development and deployment could be considered, which could draw its financing initially from a levy on the proceeds from auctions of emission allowances in national trading systems in Annex 1 countries, such as the European Union Emissions Trading Scheme. A similar contribution could be considered from domestic carbon or energy taxes.

70. The principal existing mechanism for financing low-carbon technologies in developing countries remains the Clean Development Mechanism under the Kyoto Protocol. The carbon revenue streams obtained though the sale of the certified emission reductions provide incentives and resources for non-Annex 1 countries for cutting their greenhouse gas emissions even in the absence of their own binding targets. An important limitation is that a project-based approach limits the possibility of providing funding to a set of related, mutually reinforcing projects.

71. Remedying the shortcomings of the Clean Development Mechanism is a high international priority. There have been some noteworthy initiatives developed to address the bias against small-scale projects and projects in low-emissions countries. The Nairobi Framework was launched at the second session of the Conference of the Parties serving as the Meeting of the Parties to the Kyoto

Protocol, held in Nairobi from 6 to 17 November 2006, to build capacity and generate more Clean Development Mechanism projects on the African continent. The United Nations Development Programme (UNDP) MDG Carbon Facility supports projects that contribute to meeting the Millennium Development Goals, which is the purported rationale for excluding certain types of projects (for example, sequestration, destruction of industrial gases, nuclear power and large hydropower). In an effort to move beyond the project-based approach of the Clean Development Mechanism, the World Bank is developing the Carbon Partnership Facility, which will use a programme-based approach to scale up the purchase of emission reductions generated from a regional and/or sectoral portfolio of similar projects. The Carbon Partnership Facility intends to ensure a smooth transition from the first commitment period of the Kyoto Protocol to the next regime by purchasing emission reductions for at least 10 years beyond 2012.

72. Work under the United Nations Framework Convention on Climate Change continues on the development of financing options for supporting reduced emissions from deforestation and degradation (REDD), responsible for 18 per cent of global emissions but not yet covered under the Kyoto Protocol. To address the issue, the World Bank's new Forest Carbon Partnership Facility was launched in Bali. Also, at the third session of the Conference of the Parties serving as the Meeting of the Parties to the Kyoto Protocol, held in Bali, Indonesia, in December 2007, the Government of Norway announced the investment of $2.5 billion (that is to say, $500 million per year, starting in 2008) to avert deforestation. As more funding becomes available for reduced emissions from deforestation and degradation, an important priority will be to ensure that benefits do not get captured by local elites to the detriment of indigenous communities and others, whose power to establish enforceable claims to forest resources may be limited.

Questions to be addressed under the fifth sub-theme

17. How can the international community best cooperate to finance key adaptation-related investments — for example, new crop varieties — including those of particular importance to the most vulnerable countries?

18. What financing mechanisms could the international community support for collaborative research and development and commercial-scale demonstration of key technologies like carbon capture and storage?

19. How can the Clean Development Mechanism be broadened to support low-carbon energy infrastructure investment programmes in developing countries?

20. Can financing for reduced emissions from deforestation and degradation be designed in ways that ensure that indigenous groups and other poor forest dwellers share fairly in the financial returns to carbon sequestration?